

**ORDER NO. 79242**

IN THE MATTER OF POTOMAC ELECTRIC	*	BEFORE THE
POWER COMPANY'S CLASS COST OF		PUBLIC SERVICE COMMISSION
SERVICE AND REVENUE REQUIREMENTS	*	OF MARYLAND
STUDY FOR DISTRUBUTION SERVICE		_____
	*	CASE NO. 8995
_____	*	_____

**I. BACKGROUND**

On April 11, 2002 the Public Service Commission of Maryland (“PSC” or “Commission”) approved the merger of Potomac Electric Power Company (“Pepco” or “Company”) and Delmarva Power and Light Company dba Conectiv (“Delmarva”) in Order No. 77685 in Case No. 8890.<sup>1</sup> Section 2(a) of the Agreement of Stipulation and Settlement (“8890 Settlement”) approved in that case required Pepco to “file a class cost of service and revenue requirements study for distribution service and other information sufficient to reset its distribution service rates effective as of July 1, 2004.”<sup>2</sup> Pepco filed its class cost of service and revenue requirements study (“Study”) in this case on December 5, 2003, and the Commission instituted a review of the Company’s Study herein on January 8, 2004.<sup>3</sup> Testimony was filed in this case by the Company, the Public Service Commission Staff (“Staff”), the Maryland Office of People’s Counsel (“People’s Counsel” or “OPC”) and the Apartment and Office Building Association of Metropolitan Washington (“AOBA”).

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<sup>1</sup> *Re Potomac Electric Power Company*, 93 MDPSC 134.

<sup>2</sup> *Id.* at 149.

<sup>3</sup> The Hearing Examiner notes that Pepco has agreed a final Commission decision is not due until approximately July 9, 2004. POHE at 3, fn. 4. OPC concurs that a final Commission Order is due early in July 2004. OPC Appeal at 2.

The 8890 Settlement provides that following consideration of the Study, if the PSC determines that an increase or no change in Pepco's distribution rates would otherwise be warranted, then Pepco's rates shall be capped during the period July 1, 2004, through December 31, 2006, (the "Rate Extension Period") at the level in effect June 30, 2004.<sup>4</sup> However, if the Commission determines that a rate decrease is appropriate, the rate reduction shall apply equally to all classes of Pepco's customers and the distribution rates, as so reduced, shall be capped for the duration of the Rate Extension Period.<sup>5</sup> On June 9, 2004, the Hearing Examiner issued his Proposed Order of Hearing Examiner ("POHE"), finding that no reductions in Pepco's rates are warranted.<sup>6</sup>

On June 16, 2004, OPC and AOBA filed appeals.<sup>7</sup> In sum, OPC argues that "a decrease in rates is warranted because the record as a whole demonstrates that if OPC's recommendations are adopted, Pepco has a revenue excess."<sup>8</sup> The crux of OPC's argument is that the capital structure of Pepco's parent company should be adopted for ratemaking purposes. OPC concludes that Pepco has a revenue surplus of \$7.5 million with all of OPC's adjustments.<sup>9</sup> AOBA asserts that Pepco's Study is deficient and even though supplemental testimony was filed, the Study failed to provide the information necessary to reset Pepco's distribution rates as required by the 8890 Settlement.<sup>10</sup> AOBA concludes that the POHE should be vacated and that Pepco should be directed to re-file

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<sup>4</sup> 8890 Settlement, paragraph 2(b). 93 MDPSC 134 at 149.

<sup>5</sup> 8890 Settlement, paragraph 2(c). 93 MDPSC 134 at 150.

<sup>6</sup> POHE at 31.

<sup>7</sup> Replies were filed by Pepco and Staff on June 23, 2004. OPC also filed a Motion to waive the 15 page limit for its Memorandum on Appeal, which the Commission granted. Pepco filed a Motion to waive the page limit for its Reply Memorandum on Appeal, which the Commission also grants.

<sup>8</sup> OPC Memorandum on Appeal ("OPC Appeal") at 2.

<sup>9</sup> POHE at 11, footnote 12.

<sup>10</sup> AOBA Memorandum on Appeal ("AOBA Appeal") at 3.

its case in compliance with the 8890 Settlement.<sup>11</sup> AOBA also says the results of the re-filed case should be effective retroactive to July 1, 2004.<sup>12</sup>

## **II. COMMISSION DECISION**

### **A. Capital Structure**

The thrust of OPC's Appeal is that the determination of the cost of capital for Pepco should be based upon use of the capital structure of its parent, Pepco Holdings, Inc. ("PHI").<sup>13</sup> PHI's capital structure utilizes much less equity capital than Pepco's, which lowers overall capital costs.<sup>14</sup> Both the Company and Staff advocate using Pepco's actual capital structure to determine rates.<sup>15</sup>

OPC asserts that Pepco, the regulated utility, is being used to cross-subsidize the unregulated operations of its parent, PHI.<sup>16</sup> According to OPC witness Hill, PHI can "offset" the risk of unregulated businesses, which PHI finances with a higher percentage of lower cost debt, if utility rates are based on the utility's capital structure with its higher costs.<sup>17</sup> Mr. Hill concludes that financing riskier unregulated enterprises with high levels of debt "would not be tenable" without the "financial cushion" provided by the utility's higher equity ratio.<sup>18</sup> OPC says the goal of using the PHI capital structure to determine

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<sup>11</sup> AOBA Appeal at 16.

<sup>12</sup> *Id.* at 5. AOBA also challenges several specific findings of the POHE. *Id.* at 7-15.

<sup>13</sup> OPC Appeal at 4.

<sup>14</sup> PHI's common equity capital is approximately 35% whereas Pepco's actual average common equity ratio is approximately 44%. POHE at 12 and 11.

<sup>15</sup> POHE at 11.

<sup>16</sup> OPC Appeal at 5-10.

<sup>17</sup> OPC Appeal at 6, citing OPC Ex. 4 at 14.

<sup>18</sup> OPC Appeal at 6, citing OPC Ex. 4 at 14. Since equity capital costs more than debt capital, a higher equity ratio raises total capital costs, which can result in higher utility rates to support the higher capital costs.

Pepco's capital costs is to improve Pepco's financial health by providing an incentive to eliminate this financial cross-subsidy.<sup>19</sup>

OPC also argues that if the capital structure of a utility is different from industry norms, an industry-average or hypothetical capital structure can be used to set rates.<sup>20</sup> OPC says that the average common equity ratio for electric utilities with investment grade debt is 40% of total capital, not the approximately 44% in Pepco's actual capital structure.<sup>21</sup> OPC concludes that it seeks to move Pepco's actual capital structure and that of PHI closer to industry norms.<sup>22</sup>

OPC also asserts that case law provides additional support for its position.<sup>23</sup> While the Commission may prefer to use the actual utility capital structure, the PSC has used a different capital structure "to correct an uneconomic structure or a structure which is unduly burdensome to ratepayers."<sup>24</sup> OPC notes that "the circumstances of a particular case will determine the proper balancing of the interests of the customers and the utility."<sup>25</sup> OPC states that Pepco's ratepayers are improperly "footing the bill" for excess equity capitalization in order to support PHI's other activities.<sup>26</sup> OPC concludes that the Commission should exercise its authority to correct this subsidization.<sup>27</sup>

The Hearing Examiner stated:

all parties agree that in the event the actual capital structure of Pepco is utilized in determining the proper rates for Pepco, then

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<sup>19</sup> OPC Appeal at 4-5.

<sup>20</sup> OPC Appeal at 10, citing Ex. 4 at 18.

<sup>21</sup> OPC Appeal at 9. However, OPC has estimated Pepco's common equity to be 42.02%. POHE at 13, footnote 15.

<sup>22</sup> OPC Appeal at 9. However, the Commission notes that a 44% common equity ratio is closer to the utility industry average than the 35% ratio recommended by OPC.

<sup>23</sup> OPC Appeal at 10-13.

<sup>24</sup> OPC Appeal at 10.

<sup>25</sup> OPC Appeal at 11.

<sup>26</sup> OPC Appeal at 13.

<sup>27</sup> OPC Appeal at 12-13.

the Company has not experienced an excessive rate of return and no reduction in rates is warranted at this time.<sup>28</sup>

The Hearing Examiner also noted “that this Commission, as well as others . . . have stated a preference for use of the utility’s actual capital structure during a proposed rate effective period, unless the existing capital structure will unnecessarily burden ratepayers.”<sup>29</sup> Furthermore, the Hearing Examiner recognized Staff’s position that use of the PHI capital structure, which differs significantly from Pepco’s, “would introduce financial risks that would affect Pepco later on and could lead to higher borrowing costs in the future.”<sup>30</sup> The Hearing Examiner concluded that Pepco’s capital structure is reasonable, no improper subsidies by Pepco ratepayers have been demonstrated, and that the equity ratio in the PHI capital structure is so low that its use would be unreasonable because it would jeopardize the financial health of Pepco.<sup>31</sup> Consequently, the Hearing Examiner determined that no decrease in Pepco’s distribution rates are warranted.<sup>32</sup>

The Commission concurs with the findings and conclusions of the Hearing Examiner regarding the appropriate capital structure. The Commission continues to prefer use of the actual utility capital structure in setting rates, unless the record shows that it will result in an unreasonable burden on ratepayers. OPC has not demonstrated a persuasive reason to deviate from using Pepco’s actual capital structure in this case. The record does not demonstrate that improper subsidies are occurring or that a lower equity level is either required or prudent at this time.

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<sup>28</sup> POHE at 10.

<sup>29</sup> POHE at 11-12. This preference was recently reiterated by the Commission in Case No. 8959. *Id.* at 12.

<sup>30</sup> POHE at 12.

<sup>31</sup> POHE at 17.

<sup>32</sup> POHE at 17. The Hearing Examiner’s determination was based upon a 10.1% return on equity and an 8.19% overall rate of return. *Id.* at 30. However, the Hearing Examiner clearly stated that the result would not change “even if all adjustments advocated by other parties in this proceeding” (other than the capital structure determined herein) are accepted. *Id.*

OPC took the position in this proceeding that PHI's capital structure, with 35% common equity, should be substituted for Pepco's for ratemaking purposes. However, in its Appeal, OPC indicates that the 40% utility industry common equity average might be reasonable.

Staff indicated that a 35% common equity ratio would introduce financial risks for Pepco that could adversely affect the utility.<sup>33</sup> Based upon the record the Hearing Examiner found such a common equity level "clearly unreasonable" because it "would be so low as to jeopardize Pepco's financial integrity."<sup>34</sup> Furthermore, "Staff . . . estimates a minimum equity ratio of around 40 percent is necessary for a distribution company, and . . . [Pepco] indicated an equity ratio below 40 percent would be harmful to a utility in the electric business."<sup>35</sup>

The record reflects, and the Commission finds, that a 40% common equity ratio represents a minimum threshold in this case. However, this minimum threshold is not necessarily the appropriate figure upon which to base rates. Company witness Moul presented evidence of a trend in the public utility industry to de-leverage electric companies.<sup>36</sup> Consequently, he concludes that "[t]he prudent choice for capital structure ratios in this case would be the Pepco structure, because it is more compatible with the industry trend toward higher common equity ratios."<sup>37</sup>

Staff reviewed the Company's capital structure and found "it is reasonable."<sup>38</sup> According to Staff witness Elert, "[g]iven that PEPCO has issued most of its current debt

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<sup>33</sup> POHE at 12.

<sup>34</sup> POHE at 15.

<sup>35</sup> POHE at 15.

<sup>36</sup> Rebuttal Testimony of Pepco witness Moul at 10-12. Docket No. 30.

<sup>37</sup> *Id.* at 12. Mr. Moul also states that nationally, regulatory agencies adopted common equity ratios averaging more than 49% in 2003. *Id.*

<sup>38</sup> Direct Testimony of Staff witness Gunter J. Elert at 5. Docket No. 24.

rather than PHI, suggests that the appropriate capital structure to use should be PEPCO's and not PHI's."<sup>39</sup> Mr. Elert also noted that there is an "imbalance" in the capital structures between PHI and Pepco, which validates use of Pepco's capital structure in this case.<sup>40</sup> Mr. Elert concluded that while a higher debt ratio for Pepco might seemingly benefit ratepayers in this case, short-term benefits could have negative long-term effects.<sup>41</sup> Finally, Mr. Elert noted that PHI's capital structure includes an affiliate that has substantial generating assets, which Pepco does not have. Mr. Elert concludes that "PHI's capital structure has too much 'stuff' to serve as the appropriate proxy for PEPCO."<sup>42</sup>

Based upon the record herein, the Commission concurs with Staff's conclusion that Pepco's distribution service rates "should be determined by the costs most directly attributable to service PEPCO's customers, including the financial costs associated with its capital structure,"<sup>43</sup> Consequently, no decrease in Pepco's distribution rates is warranted, at this time.

### **B. Adequacy of the Record**

AOBA asserts that Pepco has failed to comply with the requirement in Section 2(a) of the 8890 Settlement to file "information sufficient to reset its distribution service rates." AOBA also takes issue with the Commission's January 8, 2004 letter order establishing this case, which stated that Pepco's "filing complies with Section 2(a)."<sup>44</sup> According to AOBA, the Commission "suggested an unwarranted and inappropriate

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<sup>39</sup> *Id.* at 6. Mr. Elert also noted that use of Pepco's actual capital structure is consistent with the Commission's preference for using actual utility capital structures. *Id.*

<sup>40</sup> *Id.* at 7.

<sup>41</sup> *Id.*

<sup>42</sup> *Id.* at 8.

<sup>43</sup> See Mr. Elert's Direct Testimony at 8.

<sup>44</sup> AOBA Appeal at 2, quoting from the Commission's letter order, Docket No. 2.

predisposition of a key aspect of the case i.e., the adequacy and completeness of Pepco's filings."<sup>45</sup> Finally, "AOBA submits that this is not a 'standard' rate case."<sup>46</sup> According to AOBA, changes in Pepco's organizational structure, operations, costs and rate offerings since its last base rate proceeding are "dramatic" and therefore "baseline measures" for Pepco's costs must be re-established.<sup>47</sup>

During the pre-hearing conference, AOBA submitted a "Motion to Require Pepco to Submit Additional Testimony," arguing that Pepco's filing was deficient.<sup>48</sup> The Hearing Examiner orally denied AOBA's Motion, which AOBA says is "erroneous as a matter of law and fact."<sup>49</sup>

The Hearing Examiner addressed this issue<sup>50</sup> and noted that "while some elements of the Company's revenue requirements may be stale . . . Pepco has presented sufficient testimony and exhibits to meet its obligation for review. . . ."<sup>51</sup> Furthermore, the Hearing Examiner noted that "all parties had full opportunity to review Pepco's cost of service presentation and present their own positions within the standard time frame for a rate review proceeding."<sup>52</sup> While parts of Pepco's Study may be stale, the Hearing Examiner found that "the remedy is not to order a new re-filing, as argued by AOBA."<sup>53</sup> Instead, the Hearing Examiner ordered Pepco to make the results of a new lead lag study it is conducting available to the parties and also to file sufficient financial reports during the

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<sup>45</sup> AOBA Appeal at 2.

<sup>46</sup> AOBA Appeal at 4.

<sup>47</sup> AOBA Appeal at 4.

<sup>48</sup> AOBA Appeal at 3.

<sup>49</sup> AOBA Appeal at 6.

<sup>50</sup> POHE at 7-10.

<sup>51</sup> POHE at 7-8.

<sup>52</sup> POHE at 8.

<sup>53</sup> POHE at 8.



rate-effective period so that its earnings and cost of service may be monitored.<sup>54</sup> The Hearing Examiner noted this will permit any party that concludes Pepco's rates are excessive to file a petition for a rate reduction pursuant to Section 3(d) of the 8890 Settlement. Finally, the Hearing Examiner concluded that "Pepco has presented sufficient material on the record of this case to meet its obligations under Order No. 77685 . . ." and that no decrease in rates is warranted at this time.<sup>55</sup>

The issue in this proceeding is whether Pepco's rates should be decreased. In addition to its Study, Pepco filed supplemental direct testimony as well as rebuttal and supplemental rebuttal testimony. Staff, OPC and AOBA all filed direct testimony and some parties filed rebuttal and surrebuttal testimony. The Commission finds the record that was developed more than adequate to make a finding regarding Pepco's rates. The Commission concurs fully with the Hearing Examiner that Pepco met its obligations under the 8890 Settlement, that all parties had a full and fair opportunity to present their cases, and that based on this record no decrease in Pepco's distribution rates is warranted at this time.<sup>56</sup> For the record, the Commission did not suggest "an unwarranted and inappropriate predisposition" regarding the adequacy of Pepco's filing in the Commission's January 8, 2004, letter order. In that order the Commission simply noted that Pepco's filing was consistent with its 8890 Settlement obligation to make such a filing. No inference was made or intended by the Commission regarding the adequacy of that filing.

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<sup>54</sup> POHE at 8-9.

<sup>55</sup> POHE at 9. The Hearing Examiner also stated: "While the Case No. 8890 Settlement requires Pepco to produce a rate study . . . the Settlement does not affect the statutory burden of proof placed upon the proponent of new rates" citing § 3-112(b) of the PUC Article. POHE at 9, fn. 10.

<sup>56</sup> While AOBA alleges shortcomings in Pepco's and Staff's presentations, AOBA was free to present a more thorough analysis itself.

### C. Other Issues

OPC says the Hearing Examiner deferred a complete analysis of issues affecting Pepco's rates, relying solely on the importance of a capital structure determination and arguments on the sufficiency of the record.<sup>57</sup> OPC says certain rate base and operating income decisions in the Proposed Order should be revised.<sup>58</sup> These include: cash working capital<sup>59</sup>; administrative and general (A&G) expense<sup>60</sup>; pensions and benefits expense<sup>61</sup>; and Maryland State Income Tax.<sup>62</sup> OPC also says the return on equity should be 9.88% and the overall rate of return 7.0%.<sup>63</sup> Finally, OPC says that the burden of proof should be clarified because Pepco "has the burden to support a finding of no change in rates" based upon the 8890 Settlement.<sup>64</sup>

AOBA argues that Pepco has inadequately developed the Company's equity return requirement, its lead lag analysis and cash working capital requirements, and its Service Company charges.<sup>65</sup> AOBA says Pepco's testimony is devoid of any DCF analysis or other quantification of Pepco's required return on equity.<sup>66</sup> AOBA notes that Pepco's lead lag study was conducted in 1992, which is substantially out of date.<sup>67</sup> Finally, AOBA says Pepco has not presented the annualized impacts of the new Service Company structure on its costs of service or revenue requirements.<sup>68</sup>

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<sup>57</sup> OPC Appeal at 3 and 2.

<sup>58</sup> OPC Appeal at 3 and 15-19.

<sup>59</sup> OPC Appeal at 16.

<sup>60</sup> OPC Appeal at 17-18.

<sup>61</sup> OPC Appeal at 18.

<sup>62</sup> OPC Appeal at 18-19.

<sup>63</sup> OPC Appeal at 14.

<sup>64</sup> OPC Appeal at 4.

<sup>65</sup> AOBA Appeal at 7 and 7-15.

<sup>66</sup> AOBA Appeal at 7.

<sup>67</sup> AOBA Appeal at 12.

<sup>68</sup> AOBA Appeal at 15.

The Hearing Examiner found that based upon the record in this case the determination to utilize Pepco's actual capital structure means that "no decrease to the Company's rates will occur even if all adjustments recommended by other parties are accepted."<sup>69</sup> "[E]ven People's Counsel's own witness admits that in the event the capital structure of Pepco is utilized, then no such reduction is warranted."<sup>70</sup> Therefore, the additional issues raised by OPC and AOBA are moot. Finally, the Commission concurs with the Hearing Examiner that the 8890 Settlement did not shift the statutory burden of proof and that it was up to the other parties to demonstrate that Pepco's distribution rates should be reduced.

### **III. CONCLUSION**

The Proposed Order of Hearing Examiner is affirmed for the reasons stated herein. The Appeals of OPC and AOBA are denied.

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<sup>69</sup> POHE at 17.

<sup>70</sup> POHE at 11. OPC acknowledges that if Pepco's capital structure is adopted, Pepco has more than a \$1 million revenue deficiency, even when accepting all of OPC's adjustments. POHE at 11, footnote 12.

**IT IS THEREFORE,** this 6th day of July, in the year Two Thousand and Four,  
by the Public Service Commission of Maryland,

**ORDERED:** (1) The Proposed Order of Hearing Examiner is affirmed and  
the Potomac Electric Power Company shall make the filings required therein;

(2) The Motion of the Office of People's Counsel to waive the  
page limit requirement for its Memorandum on Appeal is granted;

(3) The Motion of the Potomac Electric Power Company to  
waive the page limit requirement for its Reply Memorandum on Appeal is granted;

(4) The Appeal of the Office of People's Counsel is denied;

(5) The Appeal of the Apartment and Office Building  
Association of Metropolitan Washington is denied;

(6) That all Motions not specifically granted are denied.

/s/ Kenneth D. Schisler

/s/ J. Joseph Curran, III

/s/ Ronald A. Guns

/s/ Harold D. Williams

/s/ Allen M. Freifeld  
Commissioners

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